RETIREMENT SYSTEM

Introduction

The City of San Diego is faced with the challenge of resolving a pension deficit estimated to be approximately $1.4 - $1.7 billion as of June 30, 2004. The liability was calculated by the former actuary for the pension plan and the City is expecting a more current valuation to be performed by a newly retained pension plan actuary. The City retained Kroll, Inc. to investigate the potential illegal acts regarding the financial disclosures as well as the underfunding of the pension system. In addition, the pension system retained Navigant to conduct an investigation into the underfunding of the pension system. Navigant's report is available on the SDCERS website. Until the Kroll investigation is complete, the financial status of the pension system is unclear.

The unfunded pension liability as well as the costs related to the post-retirement healthcare benefits are significant and need to be resolved in order to help restore the fiscal health of the City of San Diego. While the post-retirement healthcare benefits are not part of the retirement system, these benefits also have a significant unfunded liability and should be considered along with the pension liability.

Several factors that contributed to the City's current unfunded pension liability are discussed below.

Underfunding by the City

Beginning in 1996, the City paid less than the actuarially required contributions to the pension system. This underfunding was discontinued beginning in Fiscal Year 2006. Even if the City had fully funded the pension system, the deficit would have still grown due to the amortization method selected. This was exacerbated by the drain on Plan assets for the payment of contingent benefits and post-retirement healthcare benefits.

Benefit Improvements

A variety of retirement benefits have been granted since 1996. When a new or improved benefit is granted to existing employees with retroactive applicability for all prior years of service, the "Normal Cost" of the Plan increase and a "prior service liability" are also created. The prior service element of these benefits has caused a significant portion of the increase to the Plan's Unfunded Actuarial Accrued Liability (UAAL).

Net Actuarial Losses

Based upon the former Plan's actuary experience analysis, deviations from the actuarial assumptions include extremely low employee turnover, significant service purchase subsidies, pay increases above those assumed, and Retirement/Deferred Retirement Option Plan (DROP) incidence.

Use of SDCERS earnings for contingent benefits

The Plan has been assuming 8% earnings on its assets. It does not, however, retain 100% of those actual earnings in order to pay future retirement benefits. Instead, a portion is diverted to pay contingent benefits such as the Corbett Settlement and13th Check. And prior to Fiscal Year 2005, a portion of these earnings was used to pay for post-retirement healthcare benefits. The post-retirement healthcare benefits are now paid for by the City directly.

Retirement System

Average Investment Performance Below Expectations

The actual investment performance experience has in fact been 8% on average over the long-term. During the late 1990s, earnings were above 8% and the City increased benefits while making lower contributions than the actuarially required rates. When the market adjusted back to the investment return originally anticipated in the actuarial assumptions, the fiscal impact of decisions made during periods of better than anticipated earnings became evident.

Due to a number of concerns about the funding status of the Retirement System, the City implemented and accomplished several proactive measures.

Significant Events

Pension Reform Committee (September 9, 2003)

The Mayor appointed a nine-member committee to address concerns about the current unfunded liability of the SDCERS. A year later, the Committee issued its final report that included seventeen specific recommendations addressing several facets of the retirement system and unfunded liability. Recommendations 1-5 and 11-17 were approved by the Council, and recommendations 6-10 were subject to the Meet and Confer process with labor union representatives.

Gleason Settlement (July 2004)

The City entered into the "Gleason Settlement" in July 2004 because it was making annual contributions to the Retirement System below the actuarially required rates. As a result, the City terminated the agreements between the City and SDCERS known as Manager's Proposals I and II and approved a fixed amount of $130 million for Citywide contributions in Fiscal Year 2005. For Fiscal Years 2006 - 2008, the City also agreed to make contributions based on the actuarially determined funding level with the new 30-year fixed amortization period starting in Fiscal Year 2005.

Public Disclosure Ordinance (October 11, 2004)

The City Council commissioned the firm of Vinson and Elkins L.L.P. (V&E) to review the City's disclosure practices from January 1996 through February 2004 and to investigate whether the City failed to meet disclosure obligations concerning its funding of SDCERS. On September 16, 2004, V&E presented a report and recommendations to the Council. The V&E recommendations, which include the establishment of a Financial Reporting Oversight Board, a Disclosure Practices Working Group (DPWG), and document certifications, provide a greater opportunity for input and review of disclosure materials throughout the bond document development and review process. Implementation of these recommendations is intended to help insure that full, complete and accurate disclosure is produced.

Proposition G (November 2, 2004)

This voter approved Charter amendment changed the UAAL amortization period to no longer than 15 years and the benefits amortization period associated with net accumulated actuarial gains to no less than five years beginning with Fiscal Year 2009. Legal opinions currently differ on whether this charter change violates the State Constitution.

Proposition H (November 2, 2004)

This voter approved Charter amendment changed the composition of SDCERS Board to: seven citizens without personal interest in the Retirement System, four elected members from classifications of active membership (two general members, one fire safety member, and one police safety member), one elected by retiree members, and one appointed by the City Manager or designee.

Retiree Health Care (January 21, 2005)

Beginning in Fiscal Year 2005, the City paid $14.9 million for the total Citywide payment for retiree health. Of that amount, $7.9 million was paid from the health care trust taken from the Retirement System and the balance of $7.0 million was paid from City funds. In Fiscal Year 2006 City funds are being used to pay 100% of the retiree health care not including the yet to be determined accrued liability.

Multi-Year Financial Report (April 18, 2005)

The City developed a 5-year forecast of revenues and expenditures that incorporates a variety of core assumptions to assist the City with making long-term financial decisions. This is one tool the City can use to help plan necessary changes to the Retirement System structure and enhance the funded ratio.

Meet & Confer Process (May 31, 2005)

Major changes to labor agreements between the City and labor organizations include: negotiated wage freezes for Fiscal Years 2006 and 2007, projected to have an approximate $151 million positive impact on the pension liability; City Employee "pick-up" of the employee pension contribution, which will help enhance the funded ratio of the Retirement System; and eliminated benefits (i.e. DROP, the13th check, purchase of service credits ("air-time") for new employees, and all formulae except 2.5% at 55 for General Members and 3.0% at 50 for Safety Members).

City Manager's Report 05-190, "Options to Increase the Funded Ratio of the San Diego City Employees' Retirement System" (September 12, 2005)

City Council established a short-term goal to achieve an 80-85% pension funded ratio by Fiscal Year 2008 and approved the continuation of the evaluation of potential pension solutions as presented in the report. Some of the recommendations in the report included infusing approximately $600 million into the pension system to help improve the funded ratio. To obtain the $600 million several options were discussed including securitizing an ongoing City revenue stream, selling of non-productive land and the possible issuance of pension obligation bonds. Several of these recommendations are being evaluated. All require final City Council review and approval before implementation.

Further detail and an in-depth explanation of this report can be found on the City of San Diego website listed under the City Manager Reports Section:
http://clerkdoc.sannet.gov/cmr/CMRFullListSearch.html